LEGISLATIVE FISCAL REPORT
2005 Biennium
Volume 1 – Statewide Perspectives

Presented to the Fifty-eighth Legislature

Submitted by

The Legislative Fiscal Division

Helena, Montana

June, 2003

MONTANA LEGISLATIVE BRANCH

Legislative Fiscal Division

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Legislative Fiscal Analyst
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June 2003

Members of the Fifty-eighth Legislature
Members of the Legislative Finance Committee

In accordance with the provisions of Section 5-12-302, I submit the Legislative Fiscal Report for the 2005 Biennium. The report provides an overview and details of the 2005 Biennium budget for the State of Montana adopted by the 58th Legislature.

This four-volume report includes:

- Volume 1: Statewide Perspectives – This volume provides a general summary of the 2005 Biennium state budget as well as significant fiscal policy addressed by the 2003 legislature. It also contains a general reference section.
- Volume 2: Revenue Estimates – This volume provides the revenue estimates and underlying economic assumptions adopted by the 58th Legislature.
- Volumes 3 and 4: Agency Budgets – These volumes provide a detailed report of the appropriations for each agency and program contained in the general appropriations act (House Bill 2) and in other legislation.

These volumes are intended as a reference document and historical archive of legislative budget action for the use of legislators, the public, and state agencies.

Respectfully submitted,

Clayton Schenck
Legislative Fiscal Analyst

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HOW TO USE THIS REPORT

The *Legislative Fiscal Report, 2005 Biennium* is published in four volumes. The report was designed to report to the 2003 legislature and all interested parties on the fiscal actions of the 2003 legislature (including both legislation passed and stated legislative intent related to fiscal issues) and the fiscal status of state government through the 2005 biennium. It accomplishes its purpose by: 1) reporting on appropriations to and revenues of state government as determined by the legislature; and 2) discussing other fiscal issues pertaining to the state's fiscal status.

VOLUME 1

Volume 1, which includes a legislative summary, provides a "broad brush" overview and summarizes significant fiscal actions that impact more than one agency or that did not fall under the jurisdiction of a single appropriation subcommittee.

This volume contains these major sections:

- 2005 Biennium Budget Overview – an executive summary
- Legislative Budget Summary
- Budget Comparisons
- Other Budget or Fiscal Actions
- 2007 Biennium Outlook
- General Reference

Explore these sections for a summary of legislative actions. The "2005 Biennium Budget Overview" section on pages 1 through 26 provides a high level summary of the material presented in Legislative Fiscal Report.

An index in the back of *Volume 1* is the most comprehensive for the purpose of searching for information in all four volumes.

VOLUME 2

Volume 2 includes a summary and overview of the state's major revenue sources, including the general fund. It delineates the economic assumptions used to derive revenue estimates as adopted by the legislature in House Joint Resolution 2 and in other revenue bills.

VOLUMES 3 AND 4

Volumes 3 and 4 offer detailed discussions of the appropriations established by the legislature for each agency and program in state government that receives an appropriation in HB 2. Agency presentations are grouped in sections corresponding to the appropriations subcommittee addressing the agency.

VOLUME 3:

- House Bill 2 (the general appropriations act)
- A – General Government and Transportation
- B – Health and Human Services

VOLUME 4:

- C – Natural Resources and Commerce
- D – Corrections and Public Safety
- E – Education
- F – Long-range Planning

A specific agency can be located in any of three ways. The general index included in each volume provides an alphabetical listing of agencies and other topics, in conjunction with appropriate volume and page numbers. If the subcommittee addressing a given agency is known, the cover page of each section lists agencies, in order by appearance. Agency names are also visible on page headings within sections.

Volumes 3 and 4 briefly describe the agencies from all three branches of state government, as well as each program within an agency. The basic structure used for the report is consistent across agencies. These volumes detail an agency's appropriations, both in tables and narrative. These volumes present detailed discussions of present law adjustments, new proposals, new legislation, and significant fiscal issues by agency as identified by fiscal staff.

Agency budgets are presented in three tiers as required by statute:

- Base budget: the level of funding authorized by the previous legislation;
- Present law base: the additional level of funding authorized under present law to maintain operations and services at the level established by the previous legislature; and
- New proposals: appropriations to provide new non-mandated services, to change program services, to eliminate existing services, or to change sources of funding.

By making this presentation in this tiered manner, the reader is able to see how the budget evolved from the base budget to the total amount appropriated, and the incremental increases or decreases that make up the total budget.

PROPRIETARY RATE SETTING

The 1995 legislature, in HB 576, removed the requirement that proprietary – or internal service and enterprise – funds be appropriated by the legislature. Instead, as provided in Section 17-8-101, MCA, the legislature approves the rates charged for those particular services and products. It also requires the Office of Budget and Program Planning to submit a report as part of the Executive Budget. The proprietary rates that the legislature approved can be found in Section R of HB 2 (located at the beginning of *Volume 3*). There are also brief discussions of the rates in the relevant agency sections.

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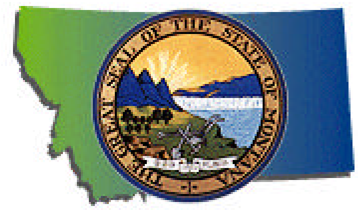
What is the state's economic profile?
How did the Legislature solve the deficit?
What were the major fiscal challenges, solutions, and issues?



INTRODUCTION: FISCAL CRISIS, CHALLENGES, & SOLUTIONS

PREFACE

For the first time in over a decade, Montana experienced a substantial 2005 biennium budget shortfall of over $230 million for the biennium relative to present law budget requirements. This came on the heels of an August 2002 special session to provide over $60 million in budget balancing actions (on top of $23 million in Governor's spending reductions) due to revenue shortfalls for fiscal 2003. The cause of the deficit was primarily due to: 1) a sharp decline in taxable income from stock options and capital gains; 2) a decline in corporation tax income; and 3) an increase in state expenditures, resulting in supplemental requests. In this challenging fiscal environment, the 58th Legislature faced the daunting task of developing a budget that preserved funding for the state's highest priority services, but also addressed the large deficit.

In this first section, we provide an executive summary of the 2005 biennium budget as adopted by the 58th Legislature. It includes a brief overview of the state fiscal picture that faced the legislature, how the legislature solved the budget deficit, and a summary of the fiscal challenges and legislative solutions to those challenges. Next, it provides highlights of the budget adopted by the legislature. A budget comparisons summary follows that provides a point of reference for the 2005 biennium budget as compared to: 1) the executive budget request; 2) present law expenditure levels; 3) the 2003 biennium; and 4) by fund type. It further includes a summary of significant budget and fiscal actions that are global in nature or relate to more than one agency (for example, the state pay plan). Finally, it includes a summary of the budget outlook for the 2007 biennium, reflecting actions taken in the 2003 session.

In a nutshell, this section provides summary answers to the following questions:

- What is Montana's economic profile?
- How did the legislature solve the deficit?
- What were the major fiscal challenges, solutions, and issues?
- What are the major highlights of the 2005 biennium budget?
- How does the 2005 biennium budget compare to:
    - The Executive Budget Proposal?
    - Present law levels of expenditure?
    - Prior biennium expenditures?
    - Fund sources?
- What other fiscal issues addressed by the 2003 legislature are important to consider?
- What might we expect for the 2007 biennium?

The items in this executive summary are presented in more detail in the remaining chapters of this volume.

2005 BIENNIUM FISCAL/ECONOMIC OUTLOOK

Montana state government, like any other business, is heavily influenced by economic and demographic developments. For example, Montana's economic base as well as the strength of the U.S. economy determines the level of revenues collected from personal and corporate income taxes, property taxes, natural resource taxes, and investment earnings. Similarly, both economic and demographic variables affect government disbursements for education, human services, corrections, and other governmental services. Montana's total revenue base is comprised of a number of taxes and fees plus numerous federal reimbursements or grants, and is further enhanced from the investment of trust monies and idle cash pending disbursement from the state treasury. Since individual income tax is the state's largest general fund tax source, economic developments or trends in the areas of employment and income levels significantly influence available revenues to fund governmental services. Conversely, Montana's total expenditure base is targeted toward educational and human service programs with a significant allocation to highway construction. These costs are driven by some of the same economic and demographic conditions that influence state revenues.

As the 2001 legislature convened over two years ago, confidence and an air of invincibility permeated reports of record economic expansions, stock market gains, and unemployment and inflation lows nationwide. Recessions and slowdowns were not a topic of fiscal policy debates. The 1990's had been generally good years for Montana's economy. With a few exceptions, Montana experienced above average employment and wage levels that translated into strong tax revenue growth. This revenue growth was further enhanced by the significant increase in the equity markets and the resulting growth in capital gains income. The 2003 legislature, however, faced a much different scenario. The effects of a national economic recession, acts of terrorism, and mid-east tensions played havoc on the US economy during the intervening two years. Montana's revenue collections dropped dramatically.

Many businesses are reluctant to invest in business expansion and possess minimal control to increase prices. Earnings reports issued by major US companies show slow growth and reduced revenues as the result of a sluggish economy. These trends translate to a similar slow-down in Montana's economy. Montana's economy is highly dependent on agriculture, tourism, natural resource extraction, and mining. All of these industries produce residual wholesale/retail trade and service sector jobs. If the basic industries are not flourishing, other sectors suffer as well. And if Montana's economy slows, tax revenue growth usually follows the trend because of the state's dependence on income tax revenues.

The irony of an economic slowdown is the inverse effect it has on state expenditures. For example, if unemployment increases, this may translate into a greater demand for human service benefits and a greater need for correctional facilities and services. During a period when revenue growth is slowing, governmental service demands usually increase at a faster rate.

The economic outlook for the state is very fragile. Employment and wage indicators continue to support slow growth in the near-term with the prospect of a gradual recovery by 2005, as is reflected in the legislative 2005 biennium revenue estimates. Capital gains income is expected to only return to pre-technology exuberance trends for calendar 2004 and 2005. While interest rates are at historic lows, corporate profits are expected to remain soft. The effects of lower interest rates may have some beneficial impacts on economic growth at the expense of reduced state revenues from investments.

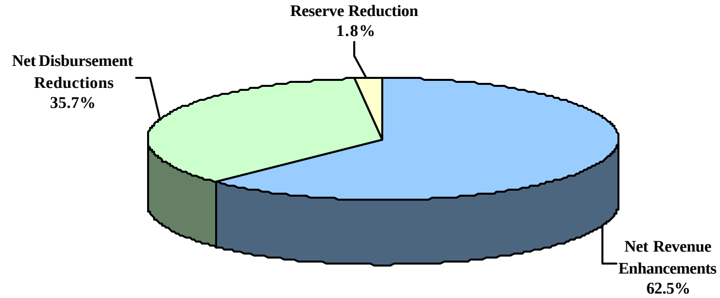
With such an economic profile, the 2003 legislature faced the difficult task of eliminating a present law budget deficit of over $230 million. The next section explains how the legislature met this challenge.

HOW THE BUDGET DEFICIT WAS SOLVED

The legislature experienced a substantial general fund budget deficit of $230.4 million for the 2005 biennium. Excluding fiscal 2003 costs of $22.4 million for supplementals and the 2003 session feed bill, the projected deficit for the 2005 biennium was $208.0 million. This amount represented the "present law" general fund dollars unavailable to fund government services at the level authorized by the previous 57th Legislature.

The 58th Legislature erased the projected general fund deficit through HB 2 reductions and the enactment of numerous pieces of other legislation. When aggregated by broad budgetary categories as shown in Figure 1, the solution was crafted with a combination of enhancing revenues by $130.0 million (62.5%), reducing disbursements by $74.2 million (35.7%), and reducing the ending fund reserve by $3.8 million (1.8%).

Figure 1
Components of Budget Deficit Solution



Budgetary Item		Millions	% of Solution
Net Revenue Enhancements		**$129.955**	**62.5%**
Revenue Legislation	135.706		
Revenue Estimate Adjustments	(5.751)		
Net Disbursement Reductions		**74.182**	**35.7%**
HB2 Adjustments from Present Law	104.877		
Other Appropriation Legislation	(38.695)		
Do Not Budget for Emergencies	8.000		
Reserve Reduction		**3.842**	**1.8%**
Total Budget Solutions		**$207.979**	

The major pieces of legislation contributing nearly $97 million of the revenue enhancements were HB 363 and SB 407. HB 363 provided for a transfer of $26.3 million from the old fund in the state worker's compensation insurance fund. SB 407 provided for new revenues from a 52 cent increase in the cigarette tax and in other tobacco products, a tax on rental cars, and a new 3 percent sales tax on lodging accommodations, offset partially in the 2005 biennium by a reduction in income taxes through income tax reform provisions.

The major other appropriations legislation was HB 1, the feed bill for the 2003 session ($6.5 million), HB 13, the state employee pay plan ($11.5 million), and HB 3 and 16, the fiscal 2003 supplemental appropriation bills ($15.7 million).

The $104.9 million in reductions from present law for the general appropriations act (HB 2) budgeted nearly all agencies below present law levels of service, for an average reduction below present law of 4.3 percent. It is important to note, however, that although there was an over $100 million reduction in general fund present law, nearly half of the reductions ($48.2 million) were due to fund switches, and the services were generally maintained by funding them with other funding sources. A list of fund switches is shown on page 98.

A further discussion of how the budget deficit was solved is on page 29.

MAJOR FISCAL CHALLENGES / SOLUTIONS / ISSUES

As discussed previously, the 2003 legislature began the session facing the worst budget deficit in years. Revenue forecasts indicated insufficient revenues to support even present law expenditures (including increased caseloads and growing prison populations), and demands for more money for schools. The volatility of revenues and an expected slow economic recovery contributed to an already dismal scenario for the 2005 biennium. What made this shortfall worse than others is that most of the "easier" solutions had been used in the fiscal 2003 Governor's Spending and August 2002 Special Session reductions.

By the end of the session, the legislature had put together a budget package that funded most agencies near the executive budget request level which was nearly $100 million below the present law level. The deficit was erased by a combination of revenue enhancers and budget cuts, with some solutions being short-term fixes and others providing long-term fixes. To put the economic and fiscal picture presented in prior sections in perspective, the following summarizes key challenges and uncertainties that the legislature had to consider in formulating the 2005 biennium spending plan and addressing related fiscal issues. Below each is a summary of legislative actions and potential remaining issues and concerns.

Fiscal Challenge

A significant budget deficit faced the 58th Legislature with a projected shortfall that would have been $232.0 million short of the amount needed to continue present law services. The legislature confronted either significantly reducing existing government services or providing additional revenues to fund existing services.

Legislative Action: The legislative budget, after excluding $22.4 million in fiscal 2003 adjustments, includes a combination of $74.2 million in expenditure reductions and $130.0 million in revenue adjustments to fund the 2005 biennium budget. These actions, plus adoption of a fund balance that is $3.8 million lower than proposed erased the projected deficit, leaving a general fund ending fund balance of $46.2 million. (see page 29)

Issue: The volatility of the national economy and of some key revenue sources continues to be a concern. The legislative revenue estimates assume a strong recovery in fiscal 2005. Monitoring revenues through the remainder of 2003 and in the 2005 biennium will be of critical importance.

Issue: About $49.3 million in expenditure reductions lack specificity in what service or operations reductions would be necessary or the impacts. A large part of this amount is related to the university system, and the recent actions (June 2003) by the Board of Regents to increase tuition are not taken into account. In some instances, reductions will be absorbed in vacancy savings as agencies leave positions open for extended periods. Other agencies will cut services. By accepting such reductions without identifying specifically where programmatic changes are to occur, the legislature has delegated those decisions to the executive as the reductions are applied.

Fiscal Challenge

Economic uncertainties continue to undermine revenue-forecasting efforts, and contribute to an increased demand for government services in areas such as human services and corrections.

Legislative Action: Although there is a great deal of concern about the ability of general fund revenues to recover in the near term, the executive budget assumed a relatively strong recovery by fiscal 2005. Legislative actions as well depend on this recovery occurring, and is supported by national forecasting outlooks subscribed to by the state. The legislature also had to deal with the pressures to provide an adequate safety net in human services, exacerbated by increased caseload due in part to a weakened economy.

Issue: Given the signs of a sluggish national economy and the inherent increase in government services demands and eligibility, are revenue estimates conservative enough, and can tight budgets in human services and corrections be sustained without cost over-runs? If the economy does not experience a relatively strong recovery in 2005, the next legislature may face a special session and/or similar deficits for the 2007 biennium.

Fiscal Challenge

Adequacy of the ending fund balance reserve needed to be evaluated by the legislature in the wake of reduced revenue growth and budget balancing reductions. What would it take to ensure that Montana has an adequate "safety net" in place?

Legislative Action: The 2005 biennium legislative budget includes a general fund ending fund balance at the end of fiscal 2005 of $46.2 million, or about 1.7 percent of total proposed general fund appropriations. This is consistent with the "target" $50 million reserves established for the past two biennia, but leaves some risk in view of volatile economic conditions. Five bills were introduced during the session proposing establishment of a "rainy day" fund. These proposals were combined into HB 624, which passed the House but failed to advance in the Senate.

Issue: In consideration of economic uncertainties and the lack of a budget for wildfire suppression, the LFD has historically suggested a moderate 2.5 percent of ongoing revenue reserve as a minimum, which would translate into a $65 million ending balance. National fiscal experts recommend a balance of 3 to 5 percent. (see page 102)

Fiscal Challenge

Controlled budget growth (structural balance) continues to be a concern if revenues fall short of expectations and "one-time revenue" fixes are used to fill gaps in the shortfall. A widening structural imbalance can translate into continuing budget problems for the legislature in future biennia.

Legislative Action: Because fiscal 2005 ongoing revenues are projected to exceed ongoing expenditures, the budget adopted by the legislature would result in a positive structural balance of $20.6 million for fiscal 2005. The budget is structurally balanced when looked at in the context of the 2005 biennium, only.

Issue: Considering structural balance for the long term is much more difficult as the status of the budget for 2005 does not take into account the potential impacts of all actions of the 2003 legislature. Further, there are statutory increases and policy issues inherent in the 2005 biennium budget that will drive up present law costs in the 2007 biennium. If revenue growth is not sufficient to fund these increases, estimated at a minimum of $100 million, then a present law deficit could occur.

For example, the revenue impacts associated with tax reform will need to be weighed against revenue growth in future years. (see page 135)

Fiscal Challenge The **fiscal 2003 budget shortfall**, although addressed by the August 2002 Special Session, was not completely resolved. A combination of revised revenue estimates, higher than expected supplemental requests, and the passage of a voter initiative reduced the 2003 projected ending cash and fund balance to a dangerously low level.

Legislative Action: The legislative budget projects an ending fund balance in fiscal 2003 of approximately $16.5 million. This balance is above the statutory minimum fund balance of approximately $6.5 million as implied by 17-7-140, MCA, which requires the Governor to reduce spending if the projected balance falls below the minimum as amended in SB 483 of the 2003 session.

Fiscal Challenge **Health care cost inflation and caseload increases** continued to be major contributors to greater than average growth in health care services budgets. Double-digit increases in state health care costs are back after several years of moderate growth. Significant service reductions were implemented in fiscal 2002 to stay within budget, and budget reductions in fiscal 2003 provided more service cutbacks. Underestimating costs could result in a budget-breaking supplemental request or further reductions in health care services.

Legislative Action: The legislature crafted Medicaid appropriations to avoid the need for service reductions and help slow the escalation in health care costs. The legislature:

- Accepted the executive Medicaid caseload and cost estimates without change
- Accepted the eligibility reductions recommended by the executive
- Accepted several actions recommended by the executive to enhance cost control efforts in the pharmacy benefits, one of the most costly and fastest growing components of the Montana Medicaid program
- Accepted the general fund reductions in Medicaid provider rates, but provided state matching funds from other sources to entirely or mostly offset provider rate reductions
- Did not accept the service reductions in the Medicaid hospice or in-home therapy services recommended by the executive, based on the rationale that cost shifts to other higher cost services and poorer health outcomes would not save as much general fund as projected in the executive budget
- Passed several bills that imposed bed day utilization fees in order to maximize Medicaid provider reimbursement to encourage continued access to services and enhance quality of medical care for all Montanans
- Passed a resolution endorsing and directing the Department of Public Health and Human Services to redesign Medicaid services for presentation to the 2005 session

Issue: The major issues facing future legislatures will continue to be the same ones that the 2003 legislature faced:

- Structuring Medicaid funded programs to serve the most needy, vulnerable citizens, while limiting cost increases

- o Negating cost shifts to other entities, including functions that are 100 percent funded by the general fund, or to counties or other potentially more expensive components of the Medicaid program
- o Making changes that are within federal criteria to maintain federal Medicaid participation and that are equitable

Fiscal Challenge

Correctional system population continues to grow. Underestimating the growth would result in a budget-breaking supplemental request, and overestimating would skew the prioritization process, taking funding away from other program areas. In addition, a recent strategy of early release of prisoners, while providing some budgetary relief, might not result in the outcome that was desired.

Legislative Action: The legislature approved funding at a level similar to that proposed by the executive. While the legislature did not specifically fund a number of decision packages, it did provide an unspecified increase and allowed the department to allocate the funds among programs.

Issue: This budget assumes a growth in average daily population for adult offenders in community corrections and secure facilities of 3.5 percent each year. The department will most likely need to implement population reduction measures to remain within the projections and appropriations. While early release was the primary measure used to achieve population reductions in the 2003 biennium, the department does not foresee it as a continued option to further reduce populations, and will rely more on the WATCh DUI program, the Missoula Assessment and Sanction Center, and the Eastmont facility in Glendive (which will be transferred to the department in fiscal 2004).

Fiscal Challenge

Funding for schools is an ongoing concern. In recent years, public schools have been faced with declining K-12 enrollments and declining budget authority without equal reductions in costs. What steps can the state take to help resolve school funding problems and maintain its relatively high achievements in performance measures?

Legislative Action: The legislature increased school district entitlements by 1.1 percent in fiscal 2004 and by 2.07 percent in fiscal 2005. The legislature paid for this increase by requiring federal funds to pay retirement costs for federally salaried employees in districts and by reducing HB 124 block grants to the county retirement accounts. The net result was little change in state funding for schools during the 2005 biennium, when compared with fiscal 2002 levels. The legislature did boost state spending for K-12 in the 2007 biennium by requiring that the budget for the 2007 biennium include inflation factors applied to district general fund entitlements. This should more than offset declines in enrollment that are expected to average around 1.6 percent per year for the next several years.

Fiscal Challenge

Higher education has been funded to a greater and greater degree in recent biennia with increased tuition charges, as general fund becomes a smaller share of total funding. The legislature would need to reconcile the difference between what the total state funded share of higher education should be, and what the state can afford during these times of revenue limitations.

Legislative Action: The legislature approved a 2005 biennium general fund budget for the Montana University System of $274.5 million (before pay plan), a $1.2 million dollar increase from the Executive Budget. The legislature continued about 95 percent of the August 2002 Special Session reduction into the 2005 biennium, effectively eliminating state funding for statewide present law adjustments and budget increases traditionally made for enrollment increases. The legislature did restore a portion of the special session reduction for the Extension Service, Fire Services Training School, Bureau of Mines, Forestry and Conservation Experiment Station, Community Colleges, and the Baker Grants. In its meeting subsequent to the end of the 2003 legislative session, the Montana Board of Regents authorized an average system-wide annual tuition rate increase of nearly 11.0 percent (compounded) to address unfunded cost increases. Approximately 75 percent of the August 2002 Special Session reductions continued by the legislature was recovered via tuition rate increases. Tuition rates at Montana's public postsecondary education institutions have, on average, increased over 220 percent since 1992.

Issue: The reductions from the present law level are unspecified, and abandon the per student formula that has been used in the past. The reductions are not tied to the statewide policy goals and accountability measures adopted by the Subcommittee on Postsecondary Education Policy and Budget.

Fiscal Challenge

State assumption of district courts has become a difficult issue for the Judiciary. The implementation of SB 176 (2001 session) left many questions about who (state or local jurisdictions) should be paying for what. The fiscal 2002 base contained no district court costs, so a full biennium cost had to be added to the 2005 biennium budget.

Legislative Action: The legislature provided funding for district court assumption at the Executive Budget level - $37.3 million. In addition, the legislature included a language appropriation of up to $1.8 million general fund from 2003 biennium reversions of appropriations of general fund money by the Judiciary. Legislation was passed (SB 490) clarifying to whom and how district court expenses are paid. This legislation also applies retroactive county responsibility for accumulated sick and vacation leave for county employees who became state employees upon state assumption of district court expenses, and creates a special revenue account for deposits of such payments and use by the Supreme Court for costs of the assumed leave liability. (see page 110)

Issue: Uncertainties regarding funding adequacy still remain due to the state's limited ability to control or predict those costs that vary with caseload, including juror fees, witness fees, psychiatric examinations, indigent defense, court appointed special advocate (CASA)/guardian at litems (GALs), youth court/juvenile probation, and youth in need of care.

Fiscal Challenge

Local government assistance was restructured by the 2001 legislature, in an effort to provide stable revenue sources for local programs. Local government, however, is not necessarily immune to the budget woes of the state or the economic turmoil of the state and nation.

Legislative Action: The legislature did not alter the statutory growth rate that is determined for the entitlement share pool. Local governments will therefore receive the distribution according to the provisions of HB 124 (2001 session), and were not required to share in the deficit reductions.

Fiscal Challenge

Economic development has been a high priority for the Martz administration. As the state attempts to address its economic climate, budget woes are causing state investments in economic development activities to shrink, while Montana continues to rank near the bottom in per capita income and other economic indicators.

Legislative Action: The legislature did not accept a proposal to eliminate research and commercialization grants, and carried through economic development funding at fiscal 2002 levels. The legislature passed HB 76, which restructured the Certified Community Program into the Certified Regional Development Corporation Program. Additionally, the legislature passed SB 115, which extended the sunset date on economic development funding from fiscal 2005 to fiscal 2010, and HB 564 that authorized loans to the office of economic development of up to $10 million for workforce training grants.

Fiscal Challenge

Potential **loss of federal funds** can occur when the state is forced to make budget cutbacks, especially when a significant share of general fund dollars are used as a match for federal funds. The loss of federal funds translates to reductions in services to citizens, loss of jobs in the state, and loss of “imported” money into the Montana economy.

Legislative Action: Overall legislative action increased recoupment of federal funds by the Department of Public Health and Human Services (DPHHS) due largely to bed utilization fees imposed on hospitals in HB 481 and an increase in the nursing home bed utilization in HB 705. Additionally, refinancing activities encouraged by the legislature result in more federal funding with less state fund outlays. The legislature continued many of the services and functions supported by federal funds and proposed for elimination in the Executive Budget, including:

- Provider rate taxes and increases in intergovernmental transfer payments to maximize Medicaid payments to nursing homes and hospitals
- Medicaid provider rate (proposed for reduction)
- Medicaid hospice and in-home therapy services (proposed for elimination)
- Childcare funding (proposed for reduction)

In general, the legislature placed a high priority on maintaining federal match funds, and the adopted budget resulted in a nearly negligible loss of federal funds. (see page 96)

Fiscal Challenge

Supplemental emergency appropriations for the next biennium are not budgeted for by the legislature and not accounted for in the ending fund balance. The state continues to experience supplemental appropriations each biennium, particularly for fire suppression.

Legislative Action: The 2005 biennium legislative budget does not include an amount set aside for supplemental appropriations in anticipation of "potential" expenditures, although it does call for a significant increase in the emergency appropriation. HB 152 increases the allowable statutory appropriation for declared emergencies from $12 million to $16 million. This appropriation is not included in the projected ending fund balance.

Issue: The state has historically experienced some chronic emergency costs and caseload induced cost overruns. For example, the state has experienced perennial fire costs, ranging from $0.8 million to $39.4 million over the last 11 biennia, and averaging nearly $10 million per biennium when the highest and lowest are excluded. Even though fires are not predictable events, it would be prudent to reserve funds to cover such reoccurring items. At a minimum, the legislature should consider the potential for future supplemental appropriations when determining an appropriate ending fund balance.

Fiscal Challenge

Pending litigation can impact state finances. Currently, there are two legal actions pending that seek changes and increased funding for services for the developmentally disabled: the Montana Advocacy Program (MAP) Travis D. class action lawsuit, and the Montana Association for Independent Disability Services, Inc. (MAIDS) lawsuit. There is also a lawsuit challenging the adequacy of state funding for schools.

Legislative Action: The legislature increased 2005 biennium funding for the Disability Services Division by about $3.4 million general fund and $26.3 million total funds compared to the 2003 biennium. The two most significant actions taken by the legislature that relate to services for the developmentally disabled were: 1) discontinuation of the usage of the Eastern Montana Human Services Center (Eastmont) as an institution serving developmentally disabled individuals, and 2) refinancing of services. In conjunction with the change in the mission of Eastmont, the budget was reduced by $4 million general fund for the biennium. The legislature heard testimony that this action would assist in resolution of the Travis D lawsuit. In addition, the legislature approved a number of refinancing efforts that decrease general fund required to continue developmental disability services at the current level. These refinancing efforts involve billing services for clients who are Medicaid eligible to Medicaid rather than the general fund, increasing the number of Medicaid reimbursable waiver slots that are available, and changing some Medicaid waiver definitions so that more clients and their services meet the criteria for Medicaid reimbursement.

Legislative Action: The legislature held state support for schools at fiscal 2002 levels for the 2005 biennium. It required that inflation be applied to district general fund entitlements beginning in the 2007 biennium.

Issue: In September 2002, a suit was filed in Montana's first judicial district court against the state of Montana alleging that the state has not adequately funded its K-12 school system. The suit will be heard after the first of the year in calendar 2004. It remains to be seen whether the court will consider an inflation adjustment beginning in the 2007 biennium as an adequate remedy.

LEGISLATIVE BUDGET HIGHLIGHTS

This section provides an executive summary of the legislative budget, including a discussion of the general fund ending balance projection, a summary of revenue estimates, and an appropriations summary.

GENERAL FUND

The general fund supports a majority of the general operations of the state, and represents about 40 percent of all state expenditures in the budgeted fund types. Total revenues are estimated to exceed $2.6 billion for the 2005 biennium, a 6.3 percent increase over the 2003 biennium. This represents a $157.5 million increase, of which $108.0 million is additional revenue from enactment of tax policy/revenue legislation. Most of the increase comes from four bills: HB 363 – old fund (state workers' compensation) transfer, HB 559 – vehicle registration fees, SB 294 – protested property tax, and SB 407 – income tax reduction/selective sales taxes. The legislature adopted a budget that will leave a projected ending fund balance of $46.2 million.

The projected general fund balance at the end of the current 2003 biennium is $16.5 million, a fraction of the balance anticipated when the 2001 session ended, and $10.6 million below the balance anticipated by the August 2002 Special Session. The reduced fund balance has been well chronicled but can be summarized by significant revenue shortfalls in individual and corporate income tax and a drop in interest earnings.

When the 2003 legislature opened for business in January, it faced a $230.4 million general fund deficit (assuming a $50.0 million reserve). When the session was over, the legislature had eliminated the deficit and provided for a $46.2 million reserve, which is about 1.7 percent of the estimated budget. How the legislature solved the deficit is explained in the previous chapter. The legislature adopted a revenue estimate that might be considered optimistic considering the current revenue picture, but the budget was built on the assumption of improved revenue growth as the economy moves into fiscal 2005. Both the executive and the legislative branch will be monitoring the state's revenues closely through the biennium.

The general fund appropriations for the 2005 biennium are $94.8 million (HB 2 and HB 13, only) below the total present law budget. The reduction from the present law level (a statutory reference point) is primarily due to present law program reductions in higher education, corrections, and human services. Significant funding shifts also occurred in justice and human services. The largest general fund dollar decreases were in human services, corrections, education, and justice, with military affairs receiving the only significant general fund increase over present law.

Total appropriations for statutory, local government, and non-budgeted transfers are $290.9 million, or 11.1 percent of the general fund total budget. They are subject to limited legislative review or evaluation.

GENERAL FUND REVENUE ESTIMATES

The legislature adopted revenue estimates in HJR 2 of $2.5 billion, and other legislation enacted resulted in $108.0 million in revenue increases in the 2005 biennium, for a consolidated revenue projection of $2.6 billion for the biennium. Income taxes account for 48.0 percent of the general fund revenues. Property taxes contribute 13.2 percent of the budget, and investment earnings about 4.0 percent. Total general fund revenues for the 2005 biennium are projected to increase 6.3 percent over the 2003 biennium projections.

TAX POLICY AND INITIATIVES

The 2003 legislature approved numerous bills with a general fund revenue impact. About 87 percent of the increase comes from four bills: HB 363 – old fund transfer, HB 559 – vehicle registration fees, SB 294 – protested property tax, and SB 407 – income tax reduction/selective sales taxes. The impact to revenue from all bills for the three fiscal years (2003, 2004, and 2005) is an increase of $135.7 million.

A detailed discussion of revenues in the 2005 biennium begins on page 39 of this volume.

APPROPRIATIONS HIGHLIGHTS

GENERAL FUND

For the 2005 biennium, general fund increases in HB 2, the general appropriations act, and HB 13, the employee pay plan, are $54.9 million (2.4 percent) more than the 2003 biennium, with most of the change occurring in the Judiciary because of state assumption of district court costs, the Department of Corrections, and the Department of Public Health and Human Services. The cost of the employee pay plan contributes to this increase as well. There is a large array of smaller increases and decreases in the rest of state government although, in smaller agencies, the changes can be significant. In the 2005 biennium, total general fund appropriated through these two sources is $2.3 billion, while total funds are $6.3 billion.

The 2005 biennium general fund appropriation is about $94.8 million below estimated present law (relative to HB 2 and HB13), the statutory reference point that defines full funding of state government. Reductions that contribute in part to the lower appropriations level can be categorized as follows:

- Specific service or program reductions amounted to about $13.4 million
- Unduplicated fee changes and funding switches resulted in $48.7 million (these generally result in maintaining services with other funds)
- Unspecified reductions totaled $48.6 million

These total an amount greater that the $94.8 shown above because they are partially offset by other increases.

OTHER FUNDS

Total funds increase $581.1 million (10.2 percent), with 36.2 percent of the increase attributable to state special revenue funds and 54.4 percent to federal funds. State special revenue shows significant growth due to Highway 93 and environmental bonding, use of highways funds in Department of Justice, and other miscellaneous factors. Federal funds increase $316.2 million due to increased grants (mainly in the areas of human services and K-12), transportation-related expenditures, and Medicaid caseload.

The legislature essentially tried to maintain state funding to match or maintain maintenance of effort for all federal funds, and minimize the loss of federal funds that was likely to occur with the reduction in general fund budgets that needed state funds to match federal funds. Federal funds continue to become a larger part of the total state budget.

STATE GOVERNMENT FTE

A net FTE increase of 20.24 is due primarily to increased federal funds, with a larger actual increase offset by numerous reductions.

POLICY HIGHLIGHTS BY PROGRAM AREA

K-12 education decreases $1.5 million general fund and increases $63.2 million in total funds.

- Schedule increases of 1.1 percent in fiscal 2004 and 2.07 percent in fiscal 2005 were funded
- Starting in the 2007 biennium, Base Aid schedules will have a built-in inflation factor
- Retirement costs of federally funded employees will now be funded with federal funds
- Federal funds are significantly increased, including for "No Child Left Behind"
- Enrollment continues to decline

Higher education is maintained at the 2003 biennium level, adjusted for fiscal 2003 reductions.

- The legislature generally did not fund present law adjustments or make any adjustments for enrollment increases
- The Board of Regents approved an average increase in tuition rates of about 11 percent (if calculated prior to the fiscal 2003 tuition surcharge and about 3.5 percent if including the surcharge), to address unfunded cost increases

The Department of Public Health and Human Services budget increases $11.4 million general fund and $286.4 million total funds.

- Caseload increases and new and expanded federal grants, including homeland security, primarily cause the expenditure growth
- Medicaid provider rates, services, and eligibility are reduced, and prescription drug coverage is expanded
- Eastmont Human Services Center will be closed as an institution for the developmentally disabled and the facility transferred to the Department of Corrections; the Montana Mental Health Nursing Care Center is downsized
- A number of reductions initiated in fiscal 2003 are continued, including various Medicaid and mental health reductions and elimination of expansions
- A portion of the tobacco settlement funds were diverted to other uses in this biennium, only
- Childcare is funded at the level necessary to match all available federal funds, and will decline from fiscal 2004 to fiscal 2005
- It is anticipated that monthly TANF cash assistance payments will be reduced in the fall due to increased caseloads and lack of federal funding
- Significant refinancing efforts reduce general fund and increase federal funds and state special revenue

Corrections shows a large increase due to prison population projections, but some measures will likely be necessary to either divert or reduce the length of stay of a number of inmates to stay within the appropriation.

The Department of Transportation is funded to match all anticipated federal funds (about $325 million)

- The highways state special revenue account is structurally imbalanced
- Because no open container law was passed, certain federal funds must be used for safety related activities

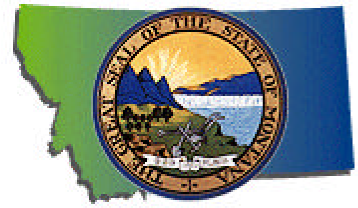
Other policy issues were addressed.

- District court assumption is funded at the level proposed by the executive, and includes authority to use up to $1.8 million of carryover from the 2003 biennium
- Over $8.7 million of highways-related expenditures in the Department of Justice are funded with highways state special revenue
- POINTS II is abandoned, and funding is provided in the Department of Labor and Industry to reassume unemployment insurance data processing
- Training grants for economic development are enhanced, and statutory appropriations are continued past the 2005 biennium
- A state employee pay plan was passed to provide additional funds to maintain costs of insurance, with a small salary increase in the last six months of fiscal 2005

A more detailed summary of appropriations in the 2003 biennium budget begins on page 55 of this volume.

How does the 2005 biennium budget compare to:

- The executive budget proposal?
- Present law levels of expenditure?
- Prior biennium expenditures?
- Fund sources?



BUDGET COMPARISONS SUMMARY

The following highlights the budget comparisons that are presented in detail beginning on page 67. The four comparisons are: 1) budget levels of the legislative 2005 biennium budget to the Governor's budget request; 2) comparisons to present law, 3) to the prior biennium expenditures', and 4) a "by fund" biennial comparison.

COMPARISON TO THE EXECUTIVE BUDGET

The 2003 legislature passed a budget in HB 2 and HB 13 that is net $3.6 million general fund higher and $137.3 million total funds higher than the level requested by Governor Martz. This difference is the net of a large number of partially offsetting increases and decreases. The major differences are:

- The legislature appropriated $10.0 general fund and $20.1 million total funds more than the executive initially proposed for the state employee pay plan.
- For K-12 education, general fund support exceeds the executive request by $6.0 million, state special revenue is $8.5 million less that proposed by the executive, and federal funds in the legislative budget exceed the executive request by $26.5 million.
- Department of Public Health and Human Services appropriations exceed the executive request by $5.0 million general fund and $48.9 million total funds. The general fund change is the net of numerous increases and decreases. Actions included initiatives to refinance certain services that resulted in general fund savings of $14.0 million and increased federal funds of $23.0 million. In addition, the state special revenue appropriation increased by about $6.0 million over the executive request, resulting primarily from an increase in tobacco prevention and control of $5.4 million.
- The Department of Corrections, while funded near the executive request level, is allowed some additional flexibility in how they allocate their funding.
- The Department of Justice general fund appropriation is $8.7 million less than the executive as highways state special revenue was used to replace some general fund costs, such as prisoner per diem and Motor Vehicle Division costs.

See page 67 in this volume for additional detail regarding the comparison of the legislative 2005 biennium budget to the Executive Budget.

COMPARISON TO PRESENT LAW

The 2005 biennium general fund budget is approximately $94.8 million below the estimated "present law" budget, defined as the level of funding needed to maintain operations and services at the level authorized by the previous legislature. The executive recommended a budget that was 98.5 million below estimated present law. For further detail, see page 70 in this volume.

The legislature took a number of actions to reduce general fund expenditures:

- Funding switches of $48.3 million that in most cases allowed services to be maintained; to the extent that a funding switch can carry forward into future biennia, total fund present law is not reduced but general fund costs are reduced
- Fee increases that replaced $0.5 million of general fund in HB 2 with revenue generated from new or expanded fees
- Service reductions of $13.4 million, which included Medicaid eligibility, childcare, the Citizen's Review Board, arts education and activities, and property tax services
- Unspecified reductions of $48.6 million that, in effect, place the decisions for staying within appropriated levels in the hands of the executive or other authority

BIENNIAL BUDGET COMPARISONS

The legislature adopted a 2005 biennium spending plan that is a $44.0 million (1.7 percent) increase in general fund, and a $593.0 million (9.4 percent) increase in total funds, when looking at all comparable appropriations. When looking at just HB 2 and HB 13, the general fund increase is $54.9 million or 2.4 percent, and the total funds increase is $581.1 million or 10.2 percent. The most significant increases in general fund appropriations occur for programs in the Judiciary ($20.5 million) because of the funding of state district court assumption costs that were not in the 2002 base, and the Department of Corrections ($15.5 million). An increase in general fund for the Department of Public Health and Human Services of $11.4 million was only a 2.2 percent increase. Total funds increase most significantly in the Department of Public Health and Human Services, the Department of Transportation, the Department of Fish, Wildlife, and Parks, and the Office of Public Instruction. The increases are somewhat distorted by fund shifts, accounting changes, and one-time expenditures that don't reflect true state costs. The discussion of budget comparisons begins on page 72 of this volume.

AGENCY BUDGET COMPARISON BY FUND

This comparison, detailed beginning on page 76, looks at appropriations contained in HB 2 and HB 13 (except for contingency funds). These are, by fund type, a comparison of the 2003 and 2005 biennium agency appropriations. The total funds increase is $581.1 million, a 10.2 percent budget increase. Federal fund increases constitute nearly 55 percent of all budget increases and state special revenue fund increases constitute 36 percent. About 9.4 percent of the increase was general fund.

General fund increases by net $54.9 million, or 2.4 percent. Major reasons for this net increase are:

- State assumption of district courts, which took place in fiscal 2003 and is not reflected in the base year (fiscal 2002).
- An increase of $14.1 million in the Department of Corrections, primarily for prison population increases.
- Reductions in K-12 enrollment and the use of federal funds to fund retirement costs of federally funded employees, only partially offset by increases of 1.1 and 2.07 percent in the Base Aid schedules.
- Refinancing, establishment of the Prevention and Stabilization Fund to replace general fund, use of tobacco prevention funds, closure of the Eastmont Human Services Center in Glendive, and use of alternate funding sources to fund increases in hospital and nursing home reimbursements in the Department of Public Health and Human Services, which partially offset increases in Medicaid caseloads, statewide present law adjustments, and other cost increases.

- o Implementation of the Challenge Program as an on-going program in the 2005 biennium in the Department of Military Affairs. Because this program was one-time-only in the 2003 biennium, expenditures do not appear in that biennium's totals.
- o A number of reductions in other agencies, including the use of state highways revenue to fund prisoner per diem and a portion of the Motor Vehicle Division in the Department of Justice.
- o HB 13, the pay plan bill, adds $10.0 million ($11.5 million if the contingency is included).

State special revenue increases by $210.4 million, or 27.7 percent, with more than half of that increase coming from increased highway construction activities including the sale of bonds for work on Highway 93 (costs of which are to be reimbursed by the federal government). Replacement of general funds by alternative funding sources, largely in the Department of Public Health and Human Services, also contributed to this increase.

Federal funds increase by $316.2 million, or 12 percent. This increase is skewed by the inclusion of $165 million in what are considered accounting changes, which means that the increase would be more like $481 million. The major increases occur in the department of Public Health and Human Services, as a result of Medicaid caseload growth, new and enhanced grant awards, and refinancing strategies; increased grant awards in the Office of Public Instruction; increased highway and airport construction activities in the Department of Transportation; and increased grants in the Departments of Fish, Wildlife, and Parks, Environmental Quality, and Military Affairs.

Proprietary funds show a net decrease of $0.4 million, or 1.6 percent, primarily due to the elimination of a debt service expense in the Montana State Lottery.

What other fiscal issues addressed by the 2003 legislature are important to consider?

HIGHLIGHTS OF OTHER BUDGET OR FISCAL ACTIONS

The "Other Budget or Fiscal Actions" section (page 83) discusses several issues of either statewide or multi-agency fiscal impact. It addresses significant issues contained in HB 2, other "cat and dog" bills, statutory appropriations, and issues not related to any specific legislation. This section provides highlights of those issues.

- **Federal Tax Law Changes/Fiscal Relief to States.** (page 85) The federal Jobs and Growth Tax Relief Reconciliation Act of 2003 was signed into law in late May 2003. A provision of this legislation appropriates $20 billion to be allocated to the states for relief from the fiscal crisis that most states have experienced as a result of lagging revenue. Montana's share has been estimated at $73 million, $50 million of which is to be used to support essential government services or to cover the costs of state compliance with unfunded federal mandates, and $23 million is for enhanced federal matching payments for Medicaid. The state (Governor) must certify that it will spend the funds in accordance with the provisions of the act. There are still questions to be answered on how these moneys can be used, but the initial allocations could come as early as June 2003 with the second allocation being allocated early in state fiscal year 2004. From a different perspective, the federal tax changes in this legislation might impact state revenue collections. The impact of the tax changes on revenue estimates won't be known until further information is available.

- **Other Appropriation Bills.** (page 89) Beside HB 2, several bills were enacted that appropriated $16.4 million in general fund and $250.9 million in other funds. The largest general fund appropriations among these bills are $11.5 million for the employee pay plan and $2.4 million for the replacement of the Department of Revenue POINTS system. Of the bills appropriating other funds, the largest appropriations are for capital projects in 7 bills providing $120.9 million, and use of $95.3 million from fees and federal matching funds for increased Medicaid payments. The latter results from strategies that allow the Department of Public Health and Human Services to leverage increased federal matching funds in spite of the general fund reductions that needed to occur because of the deficit.

- **General Fund Statutory Appropriations.** (page 92) The 2003 legislature enacted three laws that affect general fund statutory appropriations. House Bill 152 increased the Governor's $12.0 million biennial general fund statutory appropriation for declared emergencies to $16.0 million. The legislature did not include any reserve in the general fund balance for emergencies. House Bill 136 eliminated the $175,000 annual appropriation to the Office of Economic Development for business recruitment and retention. Under prior law, the appropriation would have terminated at the end of fiscal 2005. Beginning fiscal 2006, Senate Bill 115 creates eight general fund statutory appropriations totaling $6,065,000.

- **General Fund Non-budgeted Transfers.** (page 94) Over the last two biennia, an increasing amount of money has been transferred out of the general fund to other accounts that fund non-general fund programs. These transfers reduce the amount of money in the general fund that is available for general fund programs and increase the amount available for other non-general fund programs. The 2003 legislature enacted seven laws that affect general fund non-budgeted transfers:
  - House Bill 217 temporarily suspends the current law transfers to the Department of Highways state special revenue account for the 2005 biennium. Transfers are resumed beginning fiscal 2006.
  - House Bill 559, Senate Bill 112, Senate Bill 336, and Senate Bill 401 increase motor vehicle fees and deposit the increased revenue into the general fund. The money is then transferred into state special revenue accounts and used for various earmarked purposes.
  - House Bill 564 creates the Primary Business Workforce Training Program with the authorization to borrow up to $10 million for use as grants. Loan repayments are calculated on the number of new jobs created, expected to be 350 in fiscal 2004 and 800 in fiscal 2005. Additional income tax revenue to the general fund as a result of these jobs (expected to be $122,238 in fiscal 2004 and $525,709 in fiscal 2005) is transferred from the general fund to the Office of Economic Development to repay the loan.
  - House Bill 452 provides for a 30 percent income tax and corporation tax credit for contributions to a new developmental disability services state special revenue account. Thirty percent of the money in the account for which a tax credit will be claimed must be transferred to the general fund. Any amount transferred to the general fund in excess of the amount of the credits actually taken must be transferred back to the developmental disability services account. The amounts (if any) of this transfer out of the general fund are unknown.

- **Federal Match Funds Lost Due to Deficit Reduction.** (page 96) The legislature was able to minimize the loss of federal funds that was expected to occur because of general fund reductions that were necessary to eliminate the deficit. With passage of certain legislation, the Department of Public Health and Human Services was able to implement strategies to allow the department to live within the general fund cuts while maximizing the receipt of federal matching funds. The strategies include imposition of bed utilization fees for acute in-patient care facilities and nursing facilities, and using those revenues to leverage federal matching funds in making increased Medicaid payments to those facilities. The amount of federal match funds lost is approximately $0.6 million.

- **Actions to Reduce Present Law Expenditures.** (page 97) These actions are discussed in three parts. First, the legislature added over $60.2 million in other funds, and replaced almost $48.3 million in general fund. The funding switches encompass a large part of state government, with about 60 percent of the general fund replaced through three actions in human services: 1) use of tobacco settlement funds in accordance with the public initiative provisions of I-146; 2) creation of the prevention and stabilization fund; and 3) refinancing. Second, over $16.8 million in additional or new fees were added, including over $3.1 million that replaced or reduced general fund expenditures. And third, the legislature applied reductions ($13.4 million general fund) to specific programs, with the most significant dollar impact being in human services, including reduced childcare, services to the mentally ill, and Medicaid eligibility.

- **Fund Balance Adequacy.** (page 102) The legislature adopted a budget that includes an ending fund balance of $45.6 million, or 1.7 percent of the budget. This is less than the commonly recommended level of 2.5 percent and considerably less than the three to five percent level recommended by national experts.

- **Status of Tobacco Settlement Funds.** (page 104) Due to passage of Initiative 146 by the electorate in November 2002 (and as amended in SB 485 by the 2003 legislature), beginning fiscal 2004, 32 percent of the total tobacco settlement money funds tobacco prevention and human services programs and 17 percent funds the Children's Health Insurance Program and can be used to match federal Medicaid money. The remaining 11 percent of the total settlement money is deposited to the general fund. Senate Bill 485 transfers $5,831,360 in fiscal 2004 and $6,057,600 in fiscal 2005 from the account receiving the 32 percent allocation to a newly created prevention and stabilization state special revenue account. Money in the account is to be used by the Department of Public Health and Human Services to finance, administer, and provide health and human services.

- **Public School Funding.** (page 106) Compared with fiscal 2002, present law adjustments for the 2005 biennium included a reduction of $15.0 million general fund for reduced enrollment, and an increase of $13.2 million general fund for higher retirement GTB, special education, and other categorical appropriations. In addition, the legislature approved $78.1 million in increased federal appropriations for Title 1 (low income students), Special Education, Teacher Training and the "No Child Left Behind Act". Several bills were enacted that impacted school funding and are summarized later in this volume.

- **District Court Assumption.** (page 110) Prior to July 1, 2002, Montana district courts were primarily funded by the counties, except district court judge's salaries and reimbursements to counties for some costs related to criminal felony cases, which were provided by the state. This changed during the 2001 legislative session when SB 176 was enacted. Under SB 176, the district courts, with the primary exception of the clerks of court and the provision of office space, became a state-funded function. The 2003 legislature provided $37.3 million general fund in HB 2 for district court assumption. Concerned about the state's ability to control and predict certain categories of costs, the legislature added a language appropriation to HB 2 that allows up to $1.8 million additional funding from general fund reversions of the Judicial Branch. If variable costs exceed the HB 2 appropriations, the Judiciary will have to either reduce other operations or seek a supplemental appropriation.

- **POINTS Systems Replacement.** (page 112) The POINTS system is the Department of Revenue's integrated revenue and tax system, Phase I of which was implemented in 1999. The legislature approved funding for a system to replace POINTS after a decision was made to "scrap" the beleaguered system.

- **Personal Services Funding.** (page 114)
  - **<u>State Employee Pay Plan (HB 13)</u>** – The state employee pay plan passed by the legislature, which includes both a salary and insurance adjustment component, is funded with $11.5 million general fund and $17.6 million other funds. The general fund portion includes $8.2 million for increased employer contributions for health insurance, $1.9 million to fund a $0.25 per hour pay increase effective in January 2005, and $1.5 million for a personal services contingency.

- o **State Employees – FTE Summary**– HB 2 provides funding for a total 10,962.04 FTE state employees in fiscal 2004 and 11,286.46 in fiscal 2005, excluding the Montana University System. These totals represent an increase of 20.24 FTE (0.2 percent) in fiscal 2005 over the fiscal 2003 level used for budgeting purposes. This increase is the lowest in several biennia, and reflects increases due to making one-time-only programs permanent and new or enhanced federal grants and other programs. Decreases are due to a number of factors, including program elimination or curtailment and elimination of vacant FTE.
- o **Vacancy Savings** – The executive applied a 4 percent vacancy savings factor in her proposed budget. The legislature applied additional general fund reductions to most agencies, resulting in an average combined vacancy savings of 4.5 percent.

o **Proprietary Funds and Rate-Setting.** (page 120) The 2003 legislature changed one function's accounting from general fund and special revenue to internal service -- the Management Support Unit in the Department of Administration. In addition, the legislature took an additional function off budget by changing the classification of the revenue supporting Section 8 Housing in the Department of Commerce from federal funds to enterprise funds.

o **Long Range Planning Summary.** (page 122) The 2003 Legislature approved $121 million for grants, loans, and capital projects for the Long-Range Planning (LRP) programs. More detailed information can be found in Section F of Volume 4 of this report.

o **Fiscal 2003 Supplemental Appropriations.** (page 125) The legislature provided five state agencies with an additional $12.5 million general fund in fiscal 2003, nearly two-thirds ($7.9 million) of which is for fire suppression costs of the Department of Natural Resources and Conservation. Other departments receiving supplemental appropriations are the Department of Public Health and Human Services ($2.1 million), Department of Justice ($0.5 million), Montana University System ($76,000), and Office of Public Instruction ($1.9 million).

o **Fee Changes.** (page 127) Legislation resulting in fee increases, fee decreases, new fees, and additional fee payers, generating a net amount of $59.0 million, were adopted by the 2003 session. The largest portion of these increased fee revenues come from utilization or provider tax fees that are implemented to help the state maximize the use of federal matching dollars for Medicaid and from additional surcharges on court proceedings used to fund court automation efforts and to fund a portion of the law enforcement academy costs.

o **Legislative Interim Studies.** (page 129) The 2003 legislature adopted 13 joint resolutions calling for interim studies. All of the 13 studies have been assigned to various legislative interim committees. For one of these, legislative staff is being asked to prepare a "white paper".

o **Other Major Funds.** (page 130)

- o **Highways Special Revenue Account** – Projections for the highways state special revenue account indicate that expenditures from the account will exceed account revenues and the working capital balance would be depleted by the end of fiscal 2005. This situation of excess expenditures is expected to continue through the foreseeable future. Expenditures at the level appropriated by the legislature are expected to exceed revenues by nearly $32.4 million during the 2005 biennium and the account is forecast to end the 2005 biennium with a nearly depleted account balance. At the current level of services, expenditures could exceed revenues by nearly $19.8 million during the 2007 biennium.

- **Resource Indemnity Trust** – Since the RIT reached the constitutionally mandated level of $100 million, excess trust balance was available for transfer and appropriation. In the order of priority, in the 2003 biennium, the legislature transferred and appropriated: 1) $1 million for a funding switch in DNRC; 2) $300,000 for the purpose of weed eradication; 3) $540,000 for the purpose of purchasing securities for water treatment at the former Zortman and Landusky mines; 4) $120,000 for a Clark Fork River study; and 5) up to $100,000 for conservation and irrigation district grants. After these transfers, the RIT trust is estimated to be just over $100 million.
- **Combined Coal Severance Tax** – Prior to the 2002 Special Session, 8.36 percent of coal severance tax collections were allocated to the coal severance tax shared state special revenue account. During the 2002 Special Session, the legislature temporarily reduced the allocation into the shared account to 6.01 percent for fiscal 2003, and adjusted the permanent allocation to 7.75 percent to accommodate the removal of the county land planning function from the funding split within the shared account. During the 2003 session, the legislature did not accept an executive proposal to reduce the allocation to 4.18 percent, and did not pass any legislation that changed the allocation of coal severance tax revenues into the shared account. Allocation to the account for the 2005 biennium remains at 7.75 percent of coal severance tax collections. Appropriations from the account were carried through approximately equal to the fiscal 2002 level, and adjusted for projected revenues during the 2005 biennium.

2007 BIENNIUM OUTLOOK

Besides crossing our collective fingers and watching developments in state revenue sources and program caseloads, anticipating the future can be a daunting endeavor. There are many variables that can skew the outcome even in as few as a couple of years. The developments of the past two years and coming off a legislative session that had to address a $230 million deficit tend to make one cautious to say the least.

Structural balance is a key consideration in every biennium. Structural balance is defined as the matching of ongoing revenues with ongoing expenditures. If revenues equal or exceed expenditures, structural balance is achieved. Conversely, if expenditures exceed revenues, structural imbalance occurs. Projections suggest that the general fund will be structurally balanced at the end of fiscal 2005, this following a large imbalance at the end of fiscal 2003. However, as the state heads into the 2007 biennium, it faces revenue decreases and expenditure increases as a result of 2003 session legislation that are statute or policy driven. Statutory issues are revenue and expenditure budget items that are defined by current statute or that will be effective July 1, 2003. These issues must be funded during the 2007 biennium unless statutory changes are adopted by the next legislature. Policy driven issues are expenditure issues that the legislature may have some discretion in modifying based on adopted policies. A selective list of major items, as shown in Figure 2, results in an estimated impact of $103.1 million, costs that the 2005 legislature will have to address in addition to the existing base budget.

Figure 2
Major Revenue Reductions & Expenditure Increases
2007 Biennium
(in millions)

Statutory Issues		
Individual Income Tax Reductions	$17.5	
Public School Support	14.9	
Employee Pay Plan	16.5	
Local Government Entitlements	9.2	
Total Statutory		$58.1
Policy Driven Issues		
Medicaid Services	38.2	
Corrections	6.8	
Total Policy		$45.0
Estimated Total Impacts		$103.1

It should be noted that this does not reflect a complete present law analysis, and is a very conservative projection using the least discretionary selective present law projections. These items are not the only concern. Other factors might come into play such as the uncertainty of the cost of the state assumption of district court costs and the pressures to provide more state funds to higher education where tuition increases have recently been in double digits. Further, the legislature also replaced general fund with other funds in the 2005 biennium, in programs such as for prisoner per diem and the Motor Vehicle Division in the Department of Justice, and for various programs in the Department of Health and Human Services. This means that the next legislature will have to either return general fund to these programs or make other programmatic changes. Considering these potential costs, and many others that individually may seem insignificant but collectively can be significant amounts, the 2005 legislature might need to be prepared for another gloomy outlook. It will depend on whether revenue growth can match the growth in present law service cost demands.

Although the general fund is expected to be structurally balanced at the end of fiscal 2005, the issues that loom for the 2007 biennium may require the 2005 legislature to look at further programmatic reductions or consider revenue enhancement measures.

Read a more detailed discussion on this topic on page 135 in this volume.